85-1727

No.

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

ESTATE OF H. FLOYD SHERROD, H. FLOYD SHERROD, JR., and ESTALEE SHERROD SANDLIN, CO-EXECUTORS,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

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QUESTION PRESENTED

Whether certain real estate owned by the decedent at the time of his death qualifies for special use valuation for federal estate tax purposes under section 2032A of the Internal Revenue Code.

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

H. Floyd Sherrod, Jr., and Estalee Sherrod Sandlin, Co-Executors of the Estate of H. Floyd Sherrod, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eleventh Circuit (p. 1a) is reported at 774 F.2d 1057 (11th Cir. 1985). The order of the United States Court of Appeals for the Eleventh Circuit denying the Petitioners' petition for rehearing (p. 22a) is unreported.

The opinion of the United States Tax Court (p. 23a) is reported at 82 T.C. 523 (1984).

JURISDICTION

The opinion of the Court of Appeals was entered on October 25, 1985. The Petitioners' petition for rehearing was denied by the Court of Appeals on January 28, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The issue presented for review in this case is whether certain real estate owned by the decedent at the time of his death qualifies for special use valuation for federal estate tax purposes under section 2032A of the Internal Revenue Code (26 U.S.C.) as effective on the date of the decedent's death. Because of its length, section 2032A is set forth in the Appendix (p. 43a).

One of the tests involved in the determination of whether real property qualifies for special use valuation is whether the decedent or a member of his family "materially participated" in the farming operation on said real property. Section 2032A(e)(6) states that material participation shall be determined in a manner similar to the manner used for purposes of section 1402(a)(1) of the Internal Revenue Code (relating to net earnings from self-employment). Section 1402(a)(1) is also set forth in the Appendix (p. 46a).

STATEMENT OF THE CASE

H. Floyd Sherrod (the decedent) died on December 1, 1977, at the age of 87. Included in his estate were 1,478 acres of land for which his executors claimed special use valuation for federal estate tax purposes under section 2032A of the Internal Revenue Code of 1954. The land was in the form of two non-contiguous tracts, about three miles apart, in Colbert County, Alabama, one of

258 acres and the other of 700 acres, and a single tract of 520 acres in Madison County, Alabama, about 100 miles away. The total acreage of 1,478 fit neatly into three categories of land: (1) 270 acres was crop land used for growing row crops; (2) 1,108 acres was timberland; and, (3) 100 acres was pasture land. There is no dispute that each of these sections was best suited for its designated use.

Of the land in Colbert County, the tract of 700 acres was all in timber, whereas the 258-acre tract was divided among timber (48 acres), pasture (40 acres), and crop land (170 acres). At the time of the decedent's death, the timberland was in a state of natural forestation; the last cutting had occurred in 1940 or 1941. During the eight years preceding the decedent's death, the pasture land was not leased or put to any use. The crop land, on the other hand, was rented to an unrelated party. The lease for this land was for a set annual rental that was not dependent on any production which took place on that land.

Of the land in Madison County, the 520 acre tract was divided among timber (360 acres), pasture (60 acres), and crop land (100 acres). This timberland was also in a state of natural forestation; the last cutting had occurred in 1960 or 1961. Out of the 60 acres of pasture land, 28 acres were not leased or put to any use. However, the remaining 32 acres of pasture land and all 100 acres of crop land were rented to an unrelated party. These leases were also for set annual rentals not dependent on production.

On the estate's federal estate tax return, the executors elected to value the 1,478 acres under the special use valuation provisions provided by section 2032A. On audit, the Commissioner disallowed the estate's claim to special use valuation. He therefore valued all of the subject property in the gross estate at its fair market value,

based on its highest and best use, at the date of the decedent's death, and determined a deficiency in estate tax. The executors petitioned the Tax Court for a redetermination of the deficiency.

The Tax Court held for the estate. The court observed that the decedent and his son had exercised management and control over the acreage by paying the taxes on the property, inspecting the timberland, keeping in contact with the tenants and adjoining landowners, negotiating the rental agreements, and deciding whether to retain or sell the property. In the court's view, those practices were consistent with rules of sound land management and with the practices of others who held similar types of property.

Based on those findings, the Tax Court concluded that, until 1972, the decedent and his son had conducted an active farming business consisting primarily of growing and caring for 1,108 acres of timber; that this business also included the management of another 370 acres (i.e., the crop and pasture land) which constituted part of the total acreage on which the timber was located; that the management of the 370 acres was performed in such a manner that it was an integral part of, and, therefore, inseparable from, the management of the 1,108 acres of timber; and that after 1972, the decedent's son carried on this farm business on his behalf. The Commissioner appealed the Tax Court's decision to the United States Court of Appeals for the Eleventh Circuit.

Contrary to the finding of the Tax Court, the Court of Appeals found that the pasture land and the crop land did not themselves fall within the qualified use category. Furthermore, the Court of Appeals ruled that the decedent's non-timberland was not a part of an inseparable unit with the decedent's timberland. Although the decedent's timberland could be considered qualifying real property, its value represented only twenty-six percent of the overall adjusted gross estate. Because of the

Court's determination that the non-timberland was not qualifying real property in and of itself or in relationship to the timberland, the Court of Appeals ruled that the estate had failed to meet the fifty percent threshold required by section 2032A and that none of the estate's assets were entitled to special use valuation for federal estate tax purposes.

Subsequent to the issuance of the Court's opinion, the executors filed a petition for rehearing alleging certain errors in the application of the fifty percent threshold test by the Court of Appeals. This petition was supported by a brief of *amicus curiae* filed on behalf of the Illinois State Bar Association. On January 26, 1986, the Court of Appeals denied the executors' petition.

Jurisdiction in the United States Tax Court, the court of first instance, was invoked under sections 7442 and 6213 of the Internal Revenue Code (26 U.S.C.).

REASONS FOR GRANTING THE PETITION

Congress has designed section 2032A to provide relief to the heirs of family farms and other family-owned and operated businesses from the large estate tax liability that can arise from the speculative valuation of real estate used in a farm or other business at its "highest and best use." The intent of Congress was that a farm or other business retained and operated by a decedent's family would escape this high tax liability, permitting the family to continue its operation without being forced to liquidate farm or business assets to satisfy the liability. The correct application of section 2032A is necessary in order to permit the continued operation of family farms and businesses. The failure of this Court to reverse the misapplication of section 2032A by the Court of Appeals will result in significant hardship to the heirs of family farms and substantial detriment to the American agricultural industry.

The opinion of the Court of Appeals hinges upon the "qualified use" of the real property. All "qualified real property" to which the special use election applies must, on the date of the decedent's death, be used for a qualified use by the decedent or a member of the decedent's family. "Qualified use" is defined as the "devotion of the property to use as a farm for farming purposes." The terms "farm" and "farming purposes" are defined broadly and include all types of farms and farming activities. The qualified use provisions of section 2032A(b)(1) consist of two tests, the "material participation" [1] test and the "qualified use" test. As shall be seen, only the material participation test requires material participation of the decedent or a member of his family.

The qualified use test of section 2032A(b)(1)(A) requires that fifty percent or more of the value of the gross estate consist of real or personal property which on the date of the decedent's death was being devoted to a qualified use by a decedent or a member of the decedent's fam-

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[1] The term "material participation" originated from section 1402(a)(1) regarding the lease by the owner or tenant of land to another individual under which such other individual produces agricultural or horticultural commodities on such land. The major purpose of this section is to determine if the lessor's earnings from the land will be earned income for the purposes of social security. If the lease qualifies as to material participation, the rent proceeds are subject to social security taxes and are included in the determination of whether the recipient is eligible to receive social security benefits. It is assumed for the purposes of section 1402(a)(1) that a cash lease of land not based on production will not be subject to social security taxes or reduce a social security benefit. "Material participation" for section 2032A relates to the twenty-five percent test and requires that during the eight year period ending on the date of death of the decedent there have been periods of five years or more in which there was "material participation" by the decedent or a member of his family in the operation of the farm. The difference in material participation between section 1402(a)(1) and section 2032A is important. Section 1402(a)(1) relates to the lease of specific parcels of land. Section 2032A relates to the operation of the farm.

ily. There is no specific requirement under the qualified use test that the decedent or a qualified heir *materially participate* in the use to which the property is devoted. The lease of farm lands by the decedent or a member of the decedent's family for a qualified farming use should meet the qualified use test regardless of whether the lease is on a cash basis or otherwise.

The material participation test of section 2032A(b)(1)(B) and (C), which is a completely separate test from the qualified use test, relates to the ownership of the property prior to the death of the decedent. It requires that, during at least five of the eight years preceding the death of the decedent, twenty-five percent or more of the gross estate consist of real property which meets the following requirements: (1) the real property was owned by the decedent; (2) the real property was devoted to a qualified use by the decedent or a member of the decedent's family; and (3) there was material participation by the decedent or a member of the decedent's family in the operation of the farm. Under the material participation test, it is immaterial as of the date of death of the decedent whether the decedent or a member of the decedent's family materially participated in the operation of the farm, or even if they materially participated during any of the three years prior to death, so long as "material participation" occurred in the other five years. In the Court of Appeals, the Commissioner conceded that the estate met the material participation test.

Agricultural lands will either be farmed directly by the owner of the land or leased to another who actively farms the land. In each of these activities the land will be devoted to use as a farm for farming purposes. Under the qualified use test, it is the devotion of the land to agricultural purposes which is important. On the other hand, the requirement of the material participation test is that the decedent or a member of the decedent's family materially participate in the operation of the farm.

The error of the Court of Appeals is found in its determination that the 270 acres of decedent's crop lands did not meet the qualified use test. If the row crop lands do meet the test, then the estate meets all the requirements of section 2032A. The parties have previously agreed that on the date of death of the decedent these lands were being used for raising row crops. This activity is a qualified farming activity as defined by section 2032A and as of the date of death these lands were being devoted to "use as a farm for farming purposes."

In its analysis of whether the row crop land met the qualified use test, the Court of Appeals improperly applied the standards of the material participation test. The Court of Appeals specifically refers to material participation in determining whether the qualified use test is met. *Infra* at 15a. This analysis is a misapplication of section 2032A and results from commingling the separate material participation test with the qualified use test.

Any overall analysis of section 2032A will very quickly reflect that the qualified use test does not include the material participation requirement. If the interpretation of the Court of Appeals is applied to the qualified use test, it will create the following problems:

(1) The only estates which could qualify under section 2032A would be estates fifty percent or more of which consist of personal or real property which on the date of death of the decedent was being actively farmed by the decedent or a member of the decedent's family or, if the land was leased, estates in which the decedent or a member of his family materially participated in the lease as required by section 1402.

(2) The material participation test of section 2032A would be eliminated since the qualified use test would control in all instances. Under the interpretation of the Court of Appeals, it would be possible to have an estate

which would qualify under the material participation test in five of the last eight years prior to death and still not meet the Court of Appeal's "material participation" requirement in the qualified use test as of the date of death.

The error of this interpretation can already be seen in the application of the principles from the opinion below by the Court of Appeals for the Seventh Circuit in *Martin v. Commissioner*, 783 F.2d 81 (7th Cir. 1986). This case deals with the recapture of the federal estate tax saved by way of the special use valuation election upon the cessation of qualified use with respect to real property following the date of death of the decedent. Section 2032A(c)(6) specifies that the recapture tax shall be paid if the property ceases to be used for a qualified use or if there are periods aggregating more than three years during any eight year period ending after the date of the decedent's death in which there was no material participation by the decedent or a member of his family. The Seventh Circuit ruled that since the farm was cash leased for one year following the decedent's death that it had ceased to be used for a qualified use. In this ruling, the Seventh Circuit has followed the Eleventh Circuit below in emasculating the meaning of the material participation test. Even though the farm in *Martin* was under a cash lease, it was still being used as a farm; however, the Seventh Circuit has applied a material participation standard to the qualified use test such that the lack of material participation at any point will constitute a cessation of qualified use. Such an interpretation of the statute is illogical since the separate material participation test no longer has any significance and has been subsumed by the qualified use test.

(3) An individual would be unable to receive cash payments from his farmlands and his retirement benefits under the social security law and still qualify for the special use election. All leases under the Court of Ap-

peals' interpretation must meet the material participation test of section 1402 as of the date of the death of the decedent. If a lease meets the material participation requirements of section 1402, this could prevent the recipient from qualifying for social security benefits unless he is over 72 years of age. This interpretation is contrary to the express wishes of Congress as reflected in the amendment to section 2032A providing that an individual would qualify for special use election on his retirement, even though the land had been leased for a cash payment.[2]

Apart from the distinction of the qualified use and material participation tests, there remains the issue that the decedent or qualified heir must materially participate in the operation of the *farm* under section 2032A. In its opinion the Tax Court related the definitions of farm and farming purposes to the overall farming activity of the decedent. The requirements of the statute as to material participation state that such real property must be devoted to use as a farm for farming purposes and that there be material participation by the decedent or a member of the decedent's family in the *operation of the farm*. The statute does not state that there must be material participation by the decedent or a member of the decedent's family as to such real property.

The Court of Appeals referred several times to material participation on qualified real property. *Infra* at 11a and 18a. The implication of these references is that material participation is measured solely with respect to each parcel of land independently of all other parcels. The Court of Appeals did not give any consideration in its opinion to the terms "farm" and "farming purposes"

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[2] In 1981 Congress amended section 2032A(b)(4) to provide that, as to decedents who are disabled or retired, the requirements of the material participation test will not be applicable to periods when they are disabled or receiving social security benefits.

as such are used in the statute with respect to material participation.

The language of the statute, the regulations of the Commissioner, and all other applicable interpretations reflect that material participation relates to the farm and the farming operation and not to the individual tracts of land which are a part of the farm. The law clearly contemplates that some portion of the farm can be leased to others under a section 1402 lease so long as the decedent meets the material participation test as to the overall farm.

Typically, a farm will encompass real estate suitable for different purposes. The farm may have level fertile land suitable for row crops, pasture lands, timberlands, and other non-productive lands upon which no crops can be grown. The quality of the land will determine its use, yet all of the land will make up the farm and farming operation.

The Court of Appeals stated that the material participation test must be applied with respect to each land use. Despite the fact that the total acreage would be encompassed within the economic unit of a farm, the Court of Appeals determined that the decedent must materially participate in each separate use of the various tracts of land forming the farm. Non-productive lands would not qualify since these lands were not being actively farmed. The opinion of the Tax Court was very specific in its determination that material participation must be applied to the overall farming activities of the decedent. The Tax Court decision is a proper interpretation of the law and should be sustained.

SUMMARY

It is important that the Court grant this petition and decide the issue presented herein. The purpose of section 2032A is to minimize the impact of estate taxes on real

property being used for agricultural purposes. The rationale for section 2032A is illustrated by the impact of the estate taxes on the farm lands of the decedent. If these lands remain devoted to agricultural use, the only benefit to the decedent's heirs is the income which can be generated from the land. The total rental value of all the farm land at issue as reflected by the special use election is only $10,972.00. The high underlying value of the land provides no benefit to the owner unless the land is sold.

An additional problem section 2032A was designed to minimize is the problem of older farmers who are unable to materially participate in the operation of their farms. In this case the decedent was confined to a nursing home during the latter years of his life, and his son had to leave his employment as a law professor in order to return home and supervise the management of the farm lands. The provisions of section 2032A were designed to reduce this problem by providing that retired or disabled farmers can continue to receive the income from the lands without meeting the requirements of material participation as long as their lands are devoted to use as a farm for farming purposes.

The scheme of section 2032A has been substantially altered by the opinion of the Court of Appeals, and, unless modified, it will have a significant impact upon all family farms. The Court of Appeals' requirement that, as of the date of death, the decedent or member of the decedent's family must materially participate in the operation of the farm real estate will substantially modify the application of this section and adversely impact a farm family's ability to retain a farm in succeeding generations. Therefore, it is quite important that the Court grant this petition and decide the issue presented herein.

CONCLUSION

This petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX

UNITED STATES COURT OF APPEALS
ELEVENTH CIRCUIT

No. 84-7682

ESTATE OF H. FLOYD SHERROD, H. FLOYD SHERROD, JR. and ESTALEE SHERROD SANDLIN, CO-EXECUTORS,
Petitioners-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Oct. 25, 1985

Appeal from the United States Tax Court

Before HILL and CLARK, Circuit Judges, and MOYE *, District Judge.

MOYE, District Judge:

The government appeals from a decision of the tax court, 82 T.C. 523, holding that certain property of the estate of H. Floyd Sherrod (the estate) qualified for special use valuation for federal estate tax purposes un-

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* Honorable Charles A. Moye, Jr., U.S. District Judge for the Northern District of Georgia, sitting by designation.

der 26 U.S.C. § 2032A of the Internal Revenue Code of 1954. We reverse.

I.

Tax Court Proceedings

The relevant facts, as reflected in the tax court's findings, the parties' stipulations, and the evidence adduced at trial, are as follows:

H. Floyd Sherrod (the decedent) died on December 1, 1977, at the age of 87. Included in his estate were 1,478 acres of land for which the executors claimed special use valuation for federal estate tax purposes under section 2032A of the Internal Revenue Code of 1954. The land was in the form of two non-contiguous tracts, about three miles apart, in Colbert County, Alabama, one of 258 acres and the other of 700 acres, and a single tract of 520 acres in Madison County, Alabama, about 100 miles away. The total acreage of 1,478 fit neatly into three categories of land: (1) 270 acres was crop land used for growing row crops; (2) 1,108 acres was timberland; and, (3) 100 acres was pasture land. There is no dispute that each of these sections was best suited for its designated use.

Of the land in Colbert County, the tract of 700 acres was all in timber, whereas the 258-acre tract was divided among timber (48 acres), pasture (40 acres), and crop land (170 acres). At the time of the decedent's death, the timberland was in a state of natural forestation; the last cutting had occurred in 1940 or 1941. During the eight years preceding the decedent's death, the pasture land was not leased or put to any use. The crop land, on the other hand, was rented to an unrelated party. The lease for this land was for a set annual rental that was not dependent on any production which took place on that land.

Of the land in Madison County, the 520-acre tract was divided among timber (360 acres), pasture (60 acres),

and crop land (100 acres). This timberland was also in a state of forestation; the last cutting had occurred in 1960 or 1961. Out of the 60 acres of pasture land, 28 acres were not leased or put to any use. However, the remaining 32 acres of pasture land and all 100 acres of crop land were rented to an unrelated party. These leases were also for set annual rentals not dependent on production.

During his lifetime, the decedent farmed some portions of this land. However, in 1952, twenty-five years before his death, he discontinued most of his farming activities. The decedent sold his cattle and all of his farming equipment. From then until 1972, the decedent made no attempt, either directly or indirectly, to look after, raise or grow any row crops or cattle. Instead he rented out the portions of his land best suited for row crops and pasture. He did, however, during this twenty year span, continue to look after his timberland in order to protect it from trespassers, insect infestation, and disease. He did this by inspecting the timberland several times a year either alone or with his son, H. Floyd Sherrod, Jr. He and his son also maintained regular contact with the tenants and adjoining landowners. As well, the decedent paid all of the local taxes on the properties in Colbert and Madison Counties.

In the fall of 1972, the decedent entered a nursing home where he remained until his death. Just prior to entering the nursing home, the decedent executed a revocable trust into which he transferred all of his property including the 1,478 acres in question. He was the sole beneficiary of the trust during his life; his son and daughter were the trustees and also the beneficiaries of the trust at the time of his death. In 1973, the decedent's son took over the sole management of the 1,478 acres that he had previously managed with his father. Thereafter, the son alone negotiated the annual rental agreements with the tenants on the crop and pasture land, inspected the timber, maintained contacts with ad-

joining landowners, and, paid the local taxes on the property.

On the estate's federal estate tax return, the executors elected to value the 1,478 acres under the special use valuation provisions provided by 26 U.S.C. § 2032A of the Internal Revenue Code of 1954. On audit, the Commissioner disallowed the estate's claim to special use valuation. He therefore valued all of the subject property in the gross estate at its fair market value, based on its highest and best use, at the date of the decedent's death, and determined a deficiency in estate tax.[1] The

[1] On the returns, the executors claimed special use valuation for the timber on the land as well as for the underlying land itself. During the proceedings below, however, the parties agreed that the timber did not qualify for special use valuation. Accordingly, the parties stipulated to the following values for the Colbert and Madison County land:

Description	Acres	Fair Market Value	Special Use Value
Colbert County			
258-acre tract			
Crop land	170	$188,579	$ 50,678
Pasture land	40	44,371	4,916
Timberland	48	9,708	2,354
Total	258	$242,658	$ 57,948
700-acre tract			
Timberland	700	$141,572	$ 34,334
Total Colbert County	958	$384,230	$ 92,282
Madison County			
Crop land (100 acres) and rented pasture land (32 acres)	132	$ 83,655	$ 34,304
Pasture land (not rented)	28	17,745	3,560
Timberland	360	78,800	18,459
Total Madison County	520	$180,200	$ 56,323
Total Colbert and Madison Counties	1,478	$564,430	$148,605

[Continued]

executors petitioned the tax court for a redetermination of the deficiency.

In the tax court, the Commissioner argued that neither the decedent nor a member of his family put any part of the 1,478 acres to a "qualified use", within the meaning of section 2032A, at any time during the eight years preceding the decedent's death. Specifically, the Commissioner took the position that the activities of the decedent and his son during that period failed to reach the level of an active trade or business in which they materially participated, either with regard to the timberland or to the rest of the land.

The tax court, however, held for the estate. The court observed that the decedent and his son had exercised management and control over the acreage by paying the taxes on the property, inspecting the timberland, keeping in contact with the tenants and adjoining landowners, negotiating the rental agreements, and deciding whether to retain or sell the property. In the court's view, those practices were consistent with rules of sound land management and with the practices of others who held similar types of property.

Based on those findings, the tax court concluded that, until 1972, the decedent and his son had conducted an active farming business consisting primarily of growing and caring for 1,108 acres of timber, that this business also included the management of another 370 acres (i.e., the crop and pasture land) which constituted part of the total acreage on which the timber was located; that the management of the 370 acres was performed in such a

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[1] [Continued]

In addition, the parties further stipulated that the adjusted value of the gross estate (taking all the properties into account at their fair market value) was $869,806.45. Thus, the fair market value ($564,430) of the property for which special use valuation was claimed exceeded 50 percent of the adjusted gross estate. See Sec. 2032A(b)(1).

manner that it was an integral part of, and, therefore, inseparable from, the management of the 1,108 acres of timber, and that after 1972, the decedent's son carried on this farm business on his behalf.[2] This appeal followed.

II.

Discussion

As a general rule, when any property is valued for the purpose of imposing a federal tax—whether income, gift, or estate—the dollar amount assigned to it rests on the notion of fair market value. *See Rushton v. Commissioner*, 498 F.2d 88, 89 (5th Cir.1974). Similarly, in implementing section 2031(a) of the Internal Revenue Code of 1954,[3] the usual estate tax provision, the general principle of the Treasury Regulations is that the fair market value of the property controls.[4]

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[2] In the second phase of its opinion, the court ruled that it lacked jurisdiction to determine whether the estate qualified to pay its tax in installments under Section 6166A. The court noted that its jurisdiction was confined to determining tax deficiencies (*i.e.*, whether the amount of tax owed by a taxpayer exceeded the tax reported as due on his return), and that the question whether the estate could pay its tax in installments would not create, or affect the amount of, any such deficiency. This Court expresses no opinion on this matter as it was not briefed or argued by either party on appeal.

[3] 26 U.S.C. § 2031 Definition of Gross Estate

(a) [as amended by Sec. 18(a)(1), Revenue Act of 1962, Pub.L. No. 87-834, 76 Stat. 960] *General.*—The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

[4] The fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treasury Regulations on Estate Tax (1954 Code), Sec. 20.2031-1(b).

In enacting 26 U.S.C. § 2032A in 1976, Congress provided a limited exception to the aforementioned general rule with respect to the valuation for federal estate tax purposes of certain family farms and other closely-held businesses. See Section 2032A of the Internal Revenue Code of 1954, as added by Section 2003(a), Tax Reform Act of 1976, Pub.L. No. 94-455, 90 Stat. 1520, and amended by Sec. 421(b)(1), Economic Recovery Tax Act of 1981, Pub.L. No. 97-34, 95 Stat. 172. Section 2032A is a highly technical provision of the Internal Revenue Code.[5] The basic intent behind this provision was to

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[5] In pertinent part, this section reads as follows:

SEC. 2032A [as added by Sec. 2003(a), Tax Reform Act of 1976, Pub.L. No. 94-455, 90 Stat. 1520].

VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY.

(a) *Value based on use under which property qualifies.*—

(1) *General rule.*—If—

(A) the decedent was (at the time of his death) a citizen or resident of the United States, and

(B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2),

then for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property.

* * * *

(b) *Qualified real property.*—

(1) [as amended by Sec. 702(d)(1), Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, and by Sec. 421(b)(1), Economic Recovery Tax Act of 1981, Pub.L. No. 97-34, 95 Stat. 172]

In general.—For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if—

(A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—

grant relief to heirs of family farms, who might otherwise find that valuation of their newly-inherited farmland at its "highest and best use" would produce such a

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(i) on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and

(ii) was acquired from or passed from the decedent to a qualified heir of the decedent.

(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C),

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and

(D) such real property is designated in the agreement referred to in subsection (d)(2).

(2) *Qualified use.*—For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes, or

(B) use in a trade or business other than the trade or business of farming.

(3) *Adjusted value.*—For purposes of paragraph (1), the term "adjusted value" means—

(A) in the case of the gross estate, the value of the gross estate for purposes of this chapter (determined without regard to this section), reduced by any amounts allowable as a deduction under paragraph (4) of section 2053(a), or

(B) in the case of any real or personal property, the value of such property for purposes of this chapter (determined without regard to this section), reduced by any amounts allowable as a deduction in respect to such property under paragraph (4) of section 2053(a).

(4) [as added by Sec. 421(b)(2), Economic Recovery Tax Act of 1981, *supra*] *Decedents who are retired or disabled.*—

large estate tax liability that they would have to liquidate the farm in order to pay the tax. See H.R.Rep. No. 94-1380, 94th Cong., 2d Sess. at 21-22, U.S.Code Cong. &

(A) *In general.*—If, on the date of the decedent's death, the requirements of paragraph (1)(C)(ii) with respect to the decedent for any property are not met, and the decedent—

(i) was receiving old-age benefits under title II of the Social Security Act for a continuous period ending on such date, or

(ii) was disabled for a continuous period ending on such date,

then paragraph (1)(C)(ii) shall be applied with respect to such property by substituting "the date on which the longer of such continuous periods began" for "the date of the decedent's death" in paragraph (1)(C).

(B) *Disabled defined.*—purposes of subparagraph (A), an individual shall be disabled if such individual has a mental or physical impairment which renders him unable to materially participate in the operation of the farm or other business.

* * * *

(e) *Definitions; special rules.*—For purposes of this section—

(3) *Certain real property included.*—In the case of real property which meets the requirements of subparagraph (C) of subsection (b)(1), residential buildings and related improvements on such real property occupied on a regular basis by the owner or lessee of such real property or by persons employed by such owner or lessee for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use shall be treated as real property devoted to the qualified use.

(4) *Farm.*—The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

(5) *Farming purposes.*—The term "farming purposes" means—

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

Admin.News pp. 2897, 3375, 3376 (1976-3 Cum.Bull. Vol. 3) 735, 755-756). Accordingly, section 2032A permits qualifying real estate to be valued for estate tax purposes on the basis of its "actual use". "Actual use valuation" has the effect of reducing the estate tax bill considerably because, typically, working family farms do not yield high annual profits.[6] However, before section

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(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

(C) (i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market.

(6) *Material participation.*—Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self-employment).

(7) *Method of valuing farms.*—

(A) *In general.*—Except as provided in subparagraph (B), the value of a farm for farming purposes shall be determined by dividing—

(i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land, by

(ii) the average annual effective interest rate for all new Federal Land Bank loans. For purposes of the preceding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

* * * *

[6] The tax relief afforded by section 2032A goes beyond simply substituting actual use for highest and best use. Section 2032A (e) (7) (A) prescribes a capitalization of earnings approach, bottomed on the "average gross cash rental for comparable land used for farming purposes." Thus, even if farming is the optimal use of particular land, the nature of farming activities may be such

2032A can be applied to real estate, several requirements established by Congress under that section must be met. The focus of the dispute in the case before us centers on two of these requirements, the "material participation" and the "qualified use" tests of section 2032A(b), both of which must be satisfied if any property of the estate is to receive special valuation treatment. The Court will now examine each of these two requirements as they pertain to the facts of this case.

The "material participation" test looks to the eight year period immediately preceding a decedent's death. During that time, there must be at least five years during which there was material participation on the part of the decedent or a member of his family with respect to the operation of a business on "qualified real property". Furthermore, the fair market value of such property must constitute at least 25 percent of the fair market value of the estate as a whole. Section 2032A(b)(1)(B), and (b)(1)(C). If both of these conditions are not met, none of the estate's property will be eligible for special use valuation. In general, there are two types of activity that can qualify as material participation if pursued to a sufficient degree by the decedent or by a member of his family. The two types are (1) actual physical labor on the farm; and, (2) sufficient involvement in important management decisions. Treasury Regulations, Sec. 20.-2032A-3(e)(1). *See also* S.Rep. No. 97-144, 97th Cong., 1st Sess. at 133, 134-135, U.S.Code Cong. & Admin.News pp. 105, 233-235 (1981-2 Cum.Bull. 412, 463-464).[7]

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that the current return is relatively low. Since the statute permits an executor to ignore the investment value of the land, and to look only to the current return, it paves the way for substantial write-downs of farm property for estate tax purposes.

[7] The Regulations give additional content to these criteria, as follows (Treasury Regulations on Estate Tax, Sec. 20.2032A-3(e)(2)):

> While they need not make all final management decisions alone, the decedent and/or family members must participate in mak-

In this case, the Commissioner concedes that the fair market value of the timberland in the decedent's estate equalled 26 percent of the fair market value of his estate as a whole. Regarding the second condition, the tax court found that the fact that the control and management of decedent's timber farm business did not take a great deal of time does not mean that there was no material participation by the decedent and, subsequently, by his son. Timber farming does not require the expenditure of much time or labor; trees take a long time to grow and are, by and large, best left to nature. The facts are clear that the decedent and, later, his son inspected the timberland at least twice a year for the 8-year-period prior to the decedent's death. The tax court found that the decedent and his son made every managerial decision and performed every act that was necessary in order to carry on the decedent's timber farming business for the last 25 years of the decedent's life. The tax court concluded that such activity constituted a sufficient showing of material participation to satisfy the dictates of section 2032A(b)(1)(C). Given the facts of this case, this Court is not prepared to find that the tax court's conclusion in this regard was incorrect as a matter of law.

The "qualified use" test looks at how the real property in question was being used by the decedent or by a mem-

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ing a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation.

Eight examples in the Regulations spell out variations on this theme and explain the approach of the Treasury to the differing factual situations.

ber of the decedent's family on the date of the decedent's death. Furthermore, the fair market value of such property, together with that of any related personalty, must equal or exceed 50 percent of the fair market value of the overall adjusted gross estate. Sec. 2032A(b)(1)(A), and (b)(3). This percentage test is intended to confine the statute's benefits to those estates which would in fact be likely to experience a genuine liquidity problem because a major part of the estate's assets is tied up in a farm or other closely-held family business. *See Estate of Geiger v. Commissioner*, 80 T.C. 484, 489 (1983) (special use valuation denied where qualifying farm property amounted to only 42 percent of the gross estate).

In this case, the Commissioner concedes that the decedent's timberland could be considered qualifying real property; however, as previously stated, the fair market value of this property represents only 26 percent of the overall adjusted gross estate.[8] Therefore, unless a sufficient amount of the decedent's crop and pasture land is determined to be qualifying real property or related personalty, the estate will not meet the 50 percent threshold of section 2032A(b)(1)(A) and none of the estate's assets will be entitled to special use valuation.

The Court notes initially that the decedent's crop and pasture land do not themselves fall within the qualified use category. Sixty-eight out of the decedent's one hundred acres of pasture land were not put to any use at all. Clearly, this land was not employed in an active trade or business of the decedent or of a member of his family as is called for in the statute. The remaining pasture land and all 270 acres of decedent's crop land were leased to unrelated parties for fixed rentals not based on the production of the land. The legislative his-

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[8] Even if the fair market value of the timber itself were taken into account along with the timberland, the estate would still fall 17 percent short of reaching the 50 percent threshold.

tory of section 2032A makes clear that, in order for land to qualify for special use valuation, a decedent's financial stake or other involvement in the land must have been more than simply that of a landlord passively collecting a fixed rental from an unrelated tenant. Whether or not the unrelated tenant ran a farm or other business on the land is irrelevant. For the purposes of "qualified use" inquiry, it does not matter to what use a tenant put the land; the focus is on what the decedent did with the land. See H.R.Rep. No. 94-1380, *supra* at 23, U.S.Code Cong. & Admin.News p. 3377 (1976-3 Cum.Bull. (Vol. 3) 757).[9] *See also Schuneman v. United States*, 570 F.Supp.

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[9] The House Report on the 1976 Act provided in relevant part as follows:

> *Qualifying Real Property.*—Real property may qualify for special use valuation if it is located in the United States and if it is devoted to either (1) use as a farm for farming purposes, or (2) use in a trade or business other than farming. In the case of either of these qualifying uses, your committee intends that there must be a trade or business use. The mere passive rental of property will not qualify. However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. For example, if A, the decedent, owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one-third interest in profits and capital, the real property would qualify for special use valuation.

The relevant Treasury Regulations, promulgated in 1980, draw upon the same active-passive distinction. Treasury Regulations on Estate Tax (1954 Code), Sec. 20.2032A-3(b)(1) (26 C.F.R.), provides in part as follows:

> Under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property to a party other than a member of the decedent's family will not qualify. The decedent or a member of the decedent's family must own an equity interest in the farm operation. A trade or business is not necessarily present even though an office and regular hours

1327 (C.D.Ill.1983), appeals pending (7th Cir. Nos. 84-2651 & 84-2888); *Estate of Trueman v. United States*, 6 Cl.Ct. 380 (1984); *Estate of Abell v. Commissioner*, 83 T.C. 696 (1984). In this case, it is clear from the facts that the decedent and his son were the prototype of a landlord passively collecting a fixed rental from an unrelated party. Any interest of the decedent and his son in the tenants' farming operations on the rented land fell far short of material participation. There is no evidence in this case that either the decedent or his son had any hand in the managerial decisions relating to the production of row crops on that land, much less that either helped to perform the actual physical labor himself. The fact that the decedent and his son paid the local property taxes, negotiated the rental agreements, and decided from time to time whether to leave their investment in the acreage is of no import; the same could be said of almost any landlord, no matter how "passive" the lease.

The executors in this action argue that in examining whether a "trade or business" exists, the same meaning should be given this term for the purposes of section 2032A as is given this term for the purposes of other sections of the Internal Revenue Code, specifically section 162. Section 162 permits the deduction of business expenses in arriving at adjusted gross income provided

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are maintained for management of income producing assets, as the term "business" is not as broad under section 2032A as under section 162.

Treasury Regulations, of course, are written by officials delegated the authority to administer the Code, and must be upheld as long as they implement the congressional mandate in some reasonable fashion. *See e.g., National Muffler Dealers Assn. v. United States*, 440 U.S. 472, 476-477, 99 S.Ct. 1304, 1306-1307, 59 L.Ed.2d 519 (1979). Here, far from departing from Congress' intent, the regulations flesh out the basic concept that a "mere passive rental" or other form of passive investment activity lacks the requisite business character of a qualifying use.

that the activity involved is a trade or business. Of course, purely investment activity is not a trade or business for the purposes of section 162. *See Higgins v. Commissioner*, 312 U.S. 212, 61 S.Ct. 475, 85 L.Ed. 783 (1941). In determining whether a trade or business exists for section 162 purposes, one must look upon the activity of the taxpayer. If such activity rises to the level of a trade or business, then the expenses associated with that activity are deductable as business expenses under section 162. The executors urge that it is essentially irrelevant that the activity with respect to an isolated part of the enterprise does not meet the required standard, so long as the sum of the activities constitute a trade or business. By analogy, the executors argue that once this Court determines that the decedent's timber farming operation was a trade or business, then all of the decedent's real property which was utilized in or related to that farming operation should be categorized as qualified real property under section 2032A.

The executors err in stating that Congress intended the words "trade or business" to have the same meaning in section 2032A as elsewhere in the Code. The import of the term "trade or business" is not unitary throughout the tax laws; rather, it may vary depending on the background and wording of the particular provision in which it appears. *See e.g., Snow v. Commissioner*, 416 U.S. 500, 502-503, 94 S.Ct. 1876, 1877-1878, 40 L.Ed.2d 336 (1974). The term, as it relates to section 2032A, should be applied sparingly in light of that section's particular objectives and its consequences for the revenue. *See Estate of Cowser v. Commissioner*, 736 F.2d 1168 (7th Cir.1984). Whatever may be true of section 162, moreover, section 2032A requires "an active trade or business use as opposed to a passive or investment" use on the part of the taxpayer-decedent himself or of a member of the decedent's family. S.Rep. No. 97-144, 97th Cong., 1st Sess. at 133, U.S.Code Cong. & Admin.News p. 233 (1981-2 Cum.Bull. 412, 463-464).

Nonetheless, the tax court appears, in principle, to have embraced the estate's argument. The tax court concluded that the decedent and his son were engaged in an active timber farming business. The tax court also found that the decedent used each of its three types of property in the manner best suited to the nature of its terrain and the quality of its soil which, it felt, was consistent with principles of good land management. The tax court further held that the practice followed by the decedent and his son of renting the crop land to other unrelated parties for fixed annual rentals was also consistent with good land management, because each of the tracts involved was too small to be farmed economically by itself and the two parcels of crop land were too far apart to be worked as a unit.[10] Not only did the tax court feel that such rentals were consistent with good land management but it also found significant the fact that the rentals helped to provide cash for paying annual expenses such as the local taxes for all of the decedent's holdings including his timberland. Under these circumstances, the tax court concluded that the decedent's non-timberland was managed in such a manner that it was an aid to, an integral part of, and inseparable from the management of the timberland. The tax court viewed the decedent's entire acreage as a single logical unit for the purposes of special use valuation under section 2032A and, accordingly, held for the estate. We feel, however, that this decision rested on an erroneous understanding of the law and must be reversed.

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[10] The executors contend on appeal that it was unrealistic to require the decedent, and later his son, to qualify as a row crop farmer as well as a timber farmer for the small amounts of row crop land he owned. However, the decedent's holdings of crop and pasture land were not small in any relevant sense. Although only one-fourth of the total in terms of acreage, these holdings were worth over $100,000 more than the timberland. It is the dollar amount, rather than simply the number of acres, that deserves precedence for purposes of levying the estate tax.

Real property physically connected to qualifying farmland is not automatically classified as qualifying real property for purposes of section 2032A. Section 2032A (e) (3) provides the statutorily-prescribed means for testing whether or not property that is not itself being put to a qualified use should, nevertheless, be treated as qualifying because of its relationship to other qualifying real property. Specifically, this section provides that nonqualifying real property must be "functionally related" to other qualifying real property.[11] In *Estate of Geiger v. Commissioner*, 80 T.C. 484 (1983), for example, the tax court did not allow the estate to aggregate the fair market value of the personalty from the decedent's hardware operation (11 percent of the decedent's adjusted

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[11] Specifically, if underlying real property passes the 25 percent test of section 2032A (b) (1) (B)—that is, it was put to a qualifying use, there was material participation in the operation of a business on it, and its fair market value equaled or exceeded 25 percent of that of the overall gross estate—then an estate can treat certain connected property as also devoted to the same qualifying use. In addition to property that is "functionally related," this includes a residence located on the land, provided that the residence is occupied by the owner or lessee of the land in order to operate the farm or other business being conducted there.

The House Report accompanying the enactment of section 2032A includes the following gloss on section 2032A (e) (3) (H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. at 24, U.S. Code Cong. & Admin. News p. 3378 (1976-3 Cum. Bull. (Vol. 3) 735, 758)):

> Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use. On the other hand, elements of value which are not related to the farm or business use (such as mineral rights) are not to be eligible for special use valuation. For example, if there is an oil lease on a farm, the full value of the mineral rights is to be taken into account for estate tax purposes. Similarly, if there are buildings or other improvements on (or contiguous with) the farm and the buildings or other improvements are neither functionally related to the farm nor qualify as a farmhouse and related improvements, these buildings and other improvements are not treated as qualified farm real property.

gross estate) with the fair market value of the assets from the decedent's farmland (42 percent of the decedent's adjusted gross estate) in order to satisfy the 50 percent test of section 2032A(b)(1)(A) because the one business was unrelated to the other. The court further noted that not even real property which was on or contiguous to a farm would have qualified for special use evaluation unless it was functionally related to the farming enterprise. *Id.* at 490.

The Commissioner argues, and we agree, that the tax court erred in its application of section 2032A(e)(3) when it treated the decedent's non-timberland as part of an inseparable unit with the decedent's timberland. Whether it was a prudent decision by the decedent and his son to rent the non-timberland or not does not change the fact that Congress has made clear that the mere passive rental of property by the decedent, even if done solely because of age or infirmity, cannot qualify for special use valuation.[12] The tax court suggested that the

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[12] It can hardly be thought that Congress was unaware that people are less active later in life. Nonetheless, the qualified use test looks to how the property was being employed "on the date of the decedent's death." This can only represent a studied conclusion on the part of the legislature that the relevant question is whether the property was being put to a qualified use or not when the decedent died, not whether a failure to do so can be attributed to the retirement, old age, or infirmity of the decedent, or to some other equally understandable cause. *See, e.g., Schuneman v. United States*, 570 F.Supp. at 1331, where the decedent's longstanding crop-share arrangement, discontinued a year and a half before she died, helped her to meet the material participation requirement but not the test of qualifying use.

Indeed, Congress amended the material participation requirement in 1981, so that the retirement or disability of a decedent is now taken into account, for the estates of decedents dying after December 31, 1981. See section 2032A(b)(4), added by section 421(b)(2), Economic Recovery Tax Act of 1981. Hence, for decedents covered by that provision (which does not apply to decedent here, who died

decedent's use of his rental income to pay the local taxes on his property helped to establish a functional relationship between the rented land and the timberland; however, the same could be said of virtually any type of passive investment such as income generated by an oil lease on a farm, one of the examples of an unrelated use cited in the legislative history accompanying section 2032A (e) (3).[13] Furthermore, the estate made no showing that the decedent and his son could not carry on the timber farming operation essentially intact without holding title to the non-timberland. The record shows that 700 acres of the decedent's timberland were in a single tract, with no contiguous crop or pasture land. The record does not even contain a hint that either the decedent or his son had a harder time farming the remaining 408 acres of timberland. Furthermore, the decedent does not appear to have been concerned about access to these 408 acres of timberland as evidenced by the fact that he rented the contiguous land to unrelated parties. In short, the only discernible relationship, functional or otherwise, between the decedent's timberland and his non-timberland is the

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in 1977), the eight-year period for material participation ends on the date that the decedent first receives certain social security retirement benefits, or becomes disabled instead of on the date of death. The clear negative pregnant of that amendment (which was only for purposes of gauging material participation) is that not even the disability of a decedent has the effect of relaxing the test of qualified use. *A fortiori*, it makes no difference here (any more than it did in *Trueman*, *Abell*, and *Schuneman*) that decedent's passive lease of his land more or less conformed with what the owners of other such property might do in his situation. Indeed, were the rule otherwise, the restrictions on granting special use valuation for passive investment assets would be virtually unenforceable.

[13] *See* note 11, supra. *See also Trueman v. United States*, 6 Cl.Ct. at 356, in which the court said, "where the use made by a decedent of his property was an investment use, no hardship to decedent's heirs results from forcing them to sell the property in order to realize its full potential value as an investment."

fact that he owned them both. This is not enough to pass muster under section 2032A(e)(3). As a result, the estate has failed to meet the 50 percent threshold required by 26 U.S.C. § 2032A(b)(1)(A). Accordingly, none of the estate's assets are entitled to special use valuation for federal estate tax purposes under 26 U.S.C. § 2032A of the Internal Revenue Code of 1954.

The judgment of the tax court is REVERSED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 84-7682

ESTATE OF H. FLOYD SHERROD, H. FLOYD SHERROD, JR., and ESTALEE SHERROD SANDLIN, CO-EXECUTORS,
Petitioners-Appellees,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appealed from the Decision of the
United States Tax Court

ON PETITION(S) FOR REHEARING

(January 28, 1986)

BEFORE: HILL and CLARK, Circuit Judges, and MOYE *, District Judge.

PER CURIAM:

The petition(s) for rehearing filed by Appellees is denied.

ENTERED FOR THE COURT:

/s/ James C. Hill
United States Circuit Judge

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* Honorable Charles A. Moye, Jr., U.S. District Judge for the Northern District of Georgia, sitting by designation.

82 T. C. No. 40

UNITED STATES TAX COURT

Docket No. 5531-82

ESTATE OF H. FLOYD SHERROD, H. FLOYD SHERROD, JR., AND ESTALEE SHERROD SANDLIN, CO-EXECUTORS,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Filed March 26, 1984

At death decedent was beneficial owner of 1,478 acres of land. During the last 25 years of his life, 1,108 acres were in timber, 270 acres in row crops, and 100 acres in pasture. All of it was under exclusive management and control of decedent until 5 years before his death when he placed it in a revocable living trust. Thereafter until his death management and control were exercised by decedent's son, who was one of the trustees. Management included (1) the negotiation of annual rental agreements on the crop and pasture lands, (2) contact from time to time with tenants to check their performance and to see if they knew of any problem with respect to the timberland, (3) supervision of timberland by personal inspection and contact with tenants and adjoining landowners to protect against trespassers, insect infestation and disease, (4) negotiation of cutting contracts and (5) payment of local taxes. *Held*, the 1,478 acres qualify for

special use valuation under section 2032A(b) and section 20.2032A-3(b)(1), Estate Tax Regs. *Held, further,* this Court is without jurisdiction to review respondent's determination that the estate does not qualify to pay the tax in installments under sections 6166 and 6166A.

J. Gilmer Blackburn and *Mark Daniel Maloney,* for the petitioner.

Linda J. Wise, for the respondent.

SHIELDS, *Judge:* Respondent determined a deficiency of $170,693.08 in the Federal estate tax due from the Estate of H. Floyd Sherrod. After concessions, the issues remaining for decision are: (1) does the estate qualify for special use valuation under section 2032A [1] for certain land; (2) does the Tax Court have jurisdiction to review respondent's determination that the estate does not qualify to pay the estate tax in installments as provided in sections 6166 and 6166A; and (3) if the Tax Court has such jurisdiction, does the estate so qualify?

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

H. Floyd Sherrod, a citizen and resident of the United States, died on December 1, 1977. At his death he was the sole beneficiary of a revocable trust which he had created on October 20, 1972 and with respect to which his two children and only surviving heirs were the trustees. After Mr. Sherrod's death, the children, H. Floyd Sherrod, Jr. and Estalee Sherrod Sandlin, qualified as the executors of his estate.

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[1] All section references are to the Internal Revenue Code of 1954, as in effect during the year in issue. All rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

Subsequently, the executors filed a Federal estate tax return on which they reported that the estate included cash, life insurance, notes receivable, miscellaneous personal items, and 13 groupings of real property, including 1,478 acres of land on which special use valuation was claimed pursuant to section 2032A. On the return the executors also made a timely election to pay the estate tax including any deficiency in installments under sections 6166 and 6166A.

After an audit the respondent issued a deficiency notice in which he determined among other things that the special valuation provisions of section 2032A were not applicable to any part of the 1,478 acres of land and that the estate did not qualify for installment payment of the estate tax. The executors, H. Floyd Sherrod, Jr. and Estalee Sherrod Sandlin, who were then residents of Alabama and Virginia, respectively, filed a timely petition for a review of the determinations made by the respondent.

Part of the 1,478 acres of land on which special use valuation was claimed was located in Colbert County, Alabama. It consisted of two non-contiguous tracts, one of 258 acres and the other of 700 acres. The balance of the land on which the special valuation was claimed consisted of a single tract containing 520 acres located in Madison County, Alabama, at a distance of about 100 miles from the Colbert County property.

At the death of Mr. Sherrod, the 700 acre tract in Colbert County was all in timber, mostly hardwoods, but with some pine and other softwoods. Of the 258 acre tract, 48 acres were in the same kind of timber and the balance of 210 acres was in row crops (170 acres) and pasture (40 acres).

At Mr. Sherrod's death, all of the timberland in Colbert County had been in a state of natural forestation for at least 80 years. The last cutting of this timber prior

to his death occurred in 1940 or 1941. This was a selective cutting and therefore the age of the timber on the land at his death in 1977 was about 45 to 50 years.

For at least eight years prior to his death, all of the crop land in Colbert County had been rented to an unrelated party under annual oral agreements for a fixed rent which was not dependent upon production. During the same period the pasture land had not been put to any use.

The parties have stipulated that the timber on the Colbert County property at the death of the decedent had a fair market value of $43,200 and that such timber does not qualify for special use valuation under section 2032A. The parties have also stipulated that the fair market values and the special use values under section 2032A, if applicable, of the Colbert County land were as follows of the date of the decedent's death:

Description	Acres	Fair Market Value	Special Use Value
Crop land	170	$188,579	$50,678
Pasture land	40	44,371	4,916
Timberland	748	151,280	36,688
Totals	958	$384,230	$92,282

At the death of Mr. Sherrod, 360 acres of the 520 acre tract in Madison County were also in timber, mostly hardwoods. This land had been in a state of natural forestation for 40 or 50 years at its acquisition by the decedent in 1952. The age of the timber on the land at the date of his death was about 15 to 20 years since the property had been subjected to a selective cutting in about 1960 or 1961.[2]

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[2] There is a contradiction in the record as to the age of this timber. Apparently through error, Mr. Bagwell, one of petitioner's experts, referred at one time to the timber as being 45 to 50 years of age at Mr. Sherrod's death, but Mr. Spears, the tenant on part

The balance of the 520 acres was in row crops (100 acres) and pasture (60 acres). From 1972 until the death of Mr. Sherrod in 1977, all of the crop land and 32 acres of the pasture land had been rented to Robert Spears, an unrelated party, under annual oral agreements for a fixed rent which was not dependent upon production. During these five years, Mr. Spears rotated corn and soy beans on the crop land and used the 32 acres of pasture land which he rented for access between the 100 acres of crop land and his adjoining farm. During this period the remaining 28 acres of pasture land was not put to any use. For at least five years prior to 1972, all of the crop land and pasture land was rented to a Mr. Jones and a Mr. Bell for use in their cattle operation. The rental agreements with Mr. Jones and Mr. Bell were similar to those with Mr. Spears in that they were annual agreements for a fixed rent which was not dependent upon production.

Here again the parties have stipulated that the timber on the Madison County property had a fair market value of $14,800 on the date of Mr. Sherrod's death, and that such timber does not qualify for special use valuation under section 2032A. The parties have also stipulated that the fair market values and the special use values under section 2032A, if applicable, of the Madison County land on the date of death were as follows:

Description	Acres	Fair Market Value	Special Use Value
Crop land	100	$ 83,655	$34,304
Pasture land (rented)	32		
Pasture land (other)	28	17,745	3,560
Timberland	360	78,800	18,459
Totals	520	$180,200	$56,323

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of the property and the owner of an adjacent farm, testified that the timber was cut about 19 or 20 years before the trial or about 1960 or 1961, that both he and Mr. Sherrod were present and that Mr. Sherrod supervised the cutting.

As previously stated, H. Floyd Sherrod, Sr., was a citizen and resident of the United States. He was also a lifelong resident of Colbert County, Alabama. He was born there in 1890 and grew up on a farm owned by his father who was a successful full time farmer.

In 1917, Mr. Sherrod inherited part of the Colbert County land from his father's estate. He acquired the balance of the Colbert County property from other members of his family at different times between 1917 and 1949. He bought the Madison County property in a single transaction in 1952.

Mr. Sherrod completed the local college for teachers and thereafter taught school and served as a school principal until 1940. During this period he also farmed on a part time basis. His farming at this time consisted of the raising of some cattle, row crops and timber on all or a part of the Colbert County property. In 1940 he retired from his position with the school system and from then until 1952 devoted all of his time to farming and to managing and looking after the properties in Colbert and Madison Counties and his other real estate holdings which by the time of his death included some residential and commercial rental properties as well as some real estate developments of a limited nature. His farming during this period included some sharecropping arrangements with respect to the crop land.

In or about 1952, when he was 62 years of age, Mr. Sherrod ceased to engage in part of his farming activities. At this time he disposed of the 40 to 50 cattle and whatever farm equipment he owned and from then until October of 1972 he made no attempt either directly or through sharecropping arrangements to personally look after, raise or grow any row crops or cattle. Instead he rented out that portion of the properties which was suited for row crops and pasture. These rentals were on the basis of annual oral agreements which were negotiated and supervised by Mr. Sherrod personally.

He, however, continued during this 20-year period to personally look after his timberland in order to protect it from trespassers, insect infestation and disease. To accomplish this, he either alone, or at times with his son, personally inspected the timberland several times a year. Between inspections he or his son maintained regular contact with the tenants of the crop and pasture land as well as with adjoining landowners and other people in the community. He also paid all of the taxes on the properties in Colbert and Madison Counties.

When the timber on the Colbert County property was removed in 1940 or 1941, the selective cutting was done by Walker Lumber Company under an oral agreement negotiated by Mr. Sherrod with Mr. Walker. The agreement apparently amounted to a sale of the standing timber by Mr. Sherrod with the price being based on the board feet obtained from the cutting. From the record it appears that a limited cutting of at least a portion of the Colbert County property was done about 1931 by Walker Lumber Company under an oral agreement with Mr. Sherrod.

The cutting of the Madison County timber which occurred about 1960 or 1961 [3] was apparently done under the direct supervision of Mr. Sherrod. A sawmill was in place on the property and Mr. Sherrod was present five days per week during the cutting. Whatever agreement existed, if any, with respect to this cutting was oral and was negotiated by him.

In October of 1972 Mr. Sherrod, who was then 82 years of age, entered a nursing home after executing a revocable trust in which he placed all of his real property including the 1,478 acres. He was the sole beneficiary of the trust during his life, and his son and daughter were the trustees. They were also the beneficiaries of the trust at his death.

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[3] See footnote 2, *supra*.

Mr. Sherrod spent the remainder of his life in the nursing home while his son, H. Floyd Sherrod, Jr.,[4] as one of the trustees of the revocable trust, performed the managerial services with respect to the 1,478 acres that had been performed in the past by his father. Shortly after being named a trustee the son moved from Georgia, where he was a professor at the University of Georgia Law School, to Alabama, where he became employed full time as an attorney with the Legal Services Corporation. This move permitted him to perform whatever services were necessary in connection with the management and control of the 1,478 acres, as well as the other properties in the trust. As his father had before him, he (1) negotiated annual rental agreements with tenants on the crop and pasture land; (2) periodically inspected the timberland, and regularly checked with the tenants, not only to make sure that they were performing as expected, but also to ascertain whether or not they were aware of any present or potential problem with respect to the timberland; (3) maintained contact with adjoining landowners and other people in the community for the same reason; and (4) saw to it that all local taxes on the properties were paid.

The total acreage of 1,478 for which the special use value was claimed falls naturally into three types of land or soil. The first type is represented by the 270 acres (170 in Colbert County and 100 in Madison County) used for row crops. This land is relatively level and naturally fertile, being mostly bottom or lowland, and is well suited for row crops such as corn and soybeans. The second type consists of the 1,108 acres (748 in Colbert County and 360 in Madison County) in timber. This is rough mountain upland with deep soil for the most part which is suitable for growing hardwood timber but is

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[4] While not exactly clear, the record indicates that the daughter, the second trustee, did not exercise any authority with respect to the property until after the decedent's death.

not suitable for row crops or pasture. The third type is represented by the 100 acres (40 in Colbert County and 60 in Madison County), classified by the parties as pasture land. Actually, however, this property is almost wasteland. It is the rolling, hilly land lying between the other two types. It has thin soil with some rock and brush and is unsuitable for row crops because it is not level and for timber because its soil is thin.

The use made of the three types of land by the decedent from 1952 to 1972 and by his son as the trustee of the trust from 1972 to the decedent's death in 1977 was consistent with the natural state of the property. In other words, each type of land was put to the use it was most suited for by its nature. Furthermore, the management of the acreage during this 25 year period was consistent with the principles of good land management as recommended to and practiced by the owners of other property of similar nature, size and location.

The number of acres owned by Mr. Sherrod and devoted to timber (1,108) was almost seven times greater than the minimum of 160 acres considered necessary for a successful timber operation. The number also represented more than the amount of acres owned by over 92 percent of the private nonindustrial timber growers in Northern Alabama and over 99 percent of the private noncorporate owners of timber land in the United States.

Under the circumstances of this particular case, the practice followed by the decedent and his son of renting the crop land to other parties for fixed annual rents was also consistent with good land management. The two parcels of crop land, 170 acres in Colbert County and 100 acres in Madison County, were each too small to warrant the purchase of the equipment necessary to profitably use them for row crops and they were too distant from each other to work as a unit. Consequently, the practice adopted by the decedent of renting these parcels to other parties, such as Robert Spears who already had the nec-

essary equipment, was not only consistent with good land management but also provided the cash with which to pay annual expenses such as local taxes. The same reasoning and conclusion would be equally applicable to the pasture land of 40 acres in Colbert County and 60 acres in Madison County.

The parties agree that the adjusted value of the gross estate for the purpose of applying both the 50 percent test of section 2032A(b)(1)(A) and the 25 percent test of section 2032A(b)(1)(B) is $869,806.45. They also agree that at Mr. Sherrod's death both the Colbert County property and the Madison County property passed to qualified heirs within the meaning of section 2032A(e)(1).

OPINION

Special Use Valuation

In this case we must decide whether the estate qualifies for the special use valuation on the 1,478 acres of land under section 2032A.[5] Prior to the enactment of

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[5] The relevant part of section 2032A is as follows:

(b) Qualified Real Property.—

(1) In general.—For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if—

(A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—

(i) on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and

(ii) was acquired from or passed from the decedent to a qualified heir of the decedent.

[Continued]

section 2032A as part of the Tax Reform Act of 1976, real property, generally speaking, was included in an estate at its fair market value based upon its highest and best use. Section 2032A, however, permits certain qualifying farms and other real property used in a trade or business to be valued for estate tax purposes according to their actual use at the time of the decedent's death. In other words, the value is arrived at by capitalizing the income derived from the actual use of the property rather than by adopting its fair market value based upon its highest and best use. Section 20.2032A-3, Estate Tax Regs.

By the enactment of section 2032A, Congress intended to limit its application to so-called family farms or busi-

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[5] [Continued]

(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C),

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and

(D) such real property is designated in the agreement referred to in subsection (d)(2).

(2) Qualified use.—For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes, or,

(B) use in a trade or business other than the trade or business of farming.

nesses.[6] Consequently, to qualify for the "special use" value the following conditions must be met: (1) the decedent at the time of his death must have been a citizen or resident of the United States; (2) the property for which the special use value is sought must be located within the United States; (3) the property must pass to a member of the decedent's family who qualifies under section 2032A; (4) such property must represent 50 percent or more of the adjusted value of the gross estate and must have been used at the decedent's death for a qualified purpose, i.e., as a farm or in a trade or business by the decedent or a member of his family; and (5) 25 percent or more of the adjusted value of the gross estate must consist of such property which during five of the eight years preceding the decedent's death was used for a qualified purpose by the decedent or a member of his family and there must have been material participation

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[6] The intent of Congress in this respect is set out in the Committee Reports as follows:

> Your committee believes that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.

H. Rept. No. 94-1380 (1976), 1976-3 (Vol. 3) C.B. 735, 755-756.

by the decedent or the member of his family in the operation of the farm or other business. See *Estate of Coon v. Commissioner*, 81 T.C. 602 (1983); *Estate of Cowser v. Commissioner*, 80 T.C. 783 (1983), on appeal (7th Cir., July 12, 1983); *Estate of Geiger v. Commissioner*, 80 T.C. 484 (1983).

The parties agree that in this case all of the above conditions have been met except those listed at (4) and (5). In other words, their disagreement is limited to whether or not property representing 50 percent or more of the adjusted value of the gross estate was being used at the decedent's death for a qualified purpose by the decedent or a member of his family and whether or not 25 percent or more of the adjusted value of the gross estate is represented by property which was used during five of the eight years preceding the decedent's death for a qualified purpose in which there was material participation by the decedent or a member of his family.

The respondent argues that no part of the 1,478 acres was being used for a qualified purpose at the decedent's death, or at any time during the eight years preceding his death, by the decedent or a member of his family. Consequently, he contends, and urges us to find, that special valuation under section 2032A is not applicable to any part of such acreage.

The petitioner argues that from 1952 to the date of his death in 1977, the decedent or a member of his family used all of the 1,478 acres in a timber farming business in which they materially participated. Consequently, they contend that the entire acreage qualifies for the special valuation provided by section 2032A. For the reasons set out hereinafter we agree with the petitioner.

Insofar as applicable to this case, the term "qualified real property" as used in section 2032A(b)(1) means real property being used at the decedent's death for a qualified use by decedent or a member of his family pro-

vided that during five of the eight years preceding his death the decedent or a member of his family owned the property, used it for a qualified use and materially participated in the operation of the farm or other business. The term *qualified use* includes "the devotion of the property to * * * use as a farm for farming purposes * * *." Section 2032A(b)(2). The term *farm* "includes * * * woodlands." Section 2032A(e)(4). The phrase *farming purposes* includes "the planting, cultivating, caring for, or cutting of trees * * *." Section 2032A(e)(5)(C)(i).

As pointed out in our findings, the decedent from 1952 to 1972 controlled and managed the 1,478 acres by devoting each type of land included therein to its best natural use. He left in a state of natural forestation the land suitable for timber (75 percent). He leased out to other parties for cash rents the part of the property (25 percent) which was not suitable for growing timber (the crop and pasture land). This practice not only provided him with cash to meet ongoing expenses such as property taxes but also permitted him to make use of the parcels which were otherwise too small and too distant from each other to permit their profitable use.

During this period the decedent controlled, supervised and managed the acreage by (1) paying the local property taxes each year; (2) inspecting the timberland several times each year; (3) regularly contacting the tenants, adjoining landowners and other people in the neighborhood so as to ascertain what, if anything, needed to be done to protect the timber from trespassers, fire, insects and disease; (4) negotiating each year the rental agreements with the tenants of the crop and pasture land; and (5) deciding each year or at least from time to time whether or not he should permit his investment to remain in the acreage.[7]

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[7] At his death the investment had a fair market value of over $630,000.

From 1972 to 1977 the acreage was held by the revocable trust and all of the activities the decedent had undertaken during the previous 20 years were provided with respect to the property by the son as the trustee of the trust. Under section 2032A the indirect ownership of the acreage by the trust and the activities of the son as the trustee are attributable to the decedent, provided the acreage was used in an "active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities." Section 20.2032A-3(b)(1), Estate Tax Regs.

Therefore, subject to our finding that their activities constituted an active business, the conclusion is inescapable that from 1952 until the decedent's death in 1977, a period of 25 years, the decedent and the son had the acreage under their exclusive control and made every management decision with respect to the property during the entire period. Furthermore, as also stated in our findings, the activities performed by them and the manner in which the properties managed were consistent with the principles of good land management as recommended to and practiced by the owners of other property of a similar nature, size and location.

We further conclude, therefore, (1) that from 1952 through 1972 the decedent managed an active farm business which consisted primarily of planting, cultivating, growing, and caring for 1,108 acres of timber;[8] (2) that the active farm business also included the management of another 370 acres not suitable for timber but which constituted part of the total acreage on which the timber was located; (3) that the management of the 370 acres was performed in such a manner that it was an aid to, an integral part of, and inseparable from the manage-

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[8] See sections 20.2032A-3(b)(1) and 20.2032A-3(g), Example 7, Estate Tax Regs. See also *St. Germain v. Commissioner*, T.C. Memo. 1959-73.

ment of the 1,108 acres of timber; (4) that from 1972 until the decedent's death in 1977 the aforesaid active farm business was conducted by the decedent's son as one of the trustees of a revocable trust which was created by the decedent and of which he was the sole beneficiary during his life; (5) that the decedent and the son materially participated in said farm business during the entire 25 year period;[9] (6) that the total agreed value of the acreage used in the aforesaid farm business of $564,430, is more than 25 percent or even 50 percent of the adjusted value of the gross estate of $869,806.45; and (7) that the entire 1,478 acres constitute qualified real property under section 2032A(b).

We have carefully considered respondent's argument to the effect that the crop land and the pasture land should be considered separately from the timberland. However, the record as a whole establishes beyond question that the entire acreage had been held and managed by the decedent and his trustee for at least 25 years as a single logical unit.

We realize, of course, that all of the 40 acres of pasture in Colbert County and 28 acres of the pasture in Madison County were not put to any use during five of the eight years preceding the decedent's death but we have found that this land was not suitable for timber or crops and apparently had little if any rental value as pasture. Furthermore, it represents only 4.6 percent of the total acreage, 11 percent of the total fair market value, and 5.7 percent of the special use value. Consequently, it has a de minimis effect upon the overal operation and upon our thinking, and its removal would not disqualify the remainder of the property under section 2032A.

We have also considered and rejected the respondent's argument that the activity of the decedent and his trus-

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[9] See section 20.2032A-3(g), Example 7, Estate Tax Regs.

tee was not extensive enough to constitute a business because they failed to construct fire trails, prune dead and undesirable growth, and thin the timber from time to time as recommended in certain treatises on timber farming. The argument is not acceptable, however, not only because the respondent has failed to establish that the recommended procedures are practical or otherwise feasible when considered in connection with the rough, mountainous terrain involved in this case, but also because the contention is somewhat analogous to arguing that a landscape artist is not in a business because he fails to include certain rocks, clouds, trees or other items in his paintings which a different artist would include when doing the same scenes.

Furthermore, the fact that the control and management of the business did not consume a great deal of time does not alter our conclusion. The decedent and his trustee made every managerial decision and performed every act that was necessary to carry on the business for 25 years. The type of business and the product grown in timber farming does not require the expenditure of a great deal of time or labor. This fact is recognized in the respondent's regulations which require that a timber or other farmer with long nonproducing seasons need devote only such time as is needed to perform all necessary business functions in order to be considered as materially participating in the farm operation. Section 20.2032A-3 (e) (1), Estate Tax Regs.

Jurisdictional Issue

In his notice of deficiency, respondent determined that the estate did not qualify to pay the estate tax in installments as provided in section 6166 or section 6166A [10]

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[10] Section 422(d) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 315, repealed section 6166A applicable to estates of decedents dying after December 31, 1981.

because the decedent did not own an interest in a closely held business. Respondent stated further:

> If a petition to the United States Tax Court is filed against the deficiency proposed herein, this issue should be made a part of the petition to be considered by the Tax Court in any redetermination of your tax liability.

The petitioner argues that since the decedent's activities constituted a business with respect to the property for which petitioner elected special use valuation, and since the business interest satisfies the two percentage tests of section 2032A(b)(1), the estate is entitled to pay the estate tax in installments. Contrary to the statement in his statutory notice, the respondent now rejoins that inasmuch as the denial of the election to pay the estate tax in installments is not attributable to a deficiency, the Tax Court does not have jurisdiction to decide the matter. We agree with respondent.

This Court has pointed out repeatedly that its jurisdiction is strictly limited by statute and that it does not have the authority to enlarge upon the statutory grant of jurisdiction. *Estate of Young v. Commissioner*, 81 T.C. 879 (1983) (court reviewed); *Medeiros v. Commissioner*, 77 T.C. 1255, 1259 (1981); *Breman v. Commissioner*, 66 T.C. 61, 66 (1976). See also section 7442 and Rule 13.

Section 6213 confers jurisdiction on the Tax Court to redetermine deficiencies in income, estate, gift, and certain excise taxes. In addition, the Court is authorized to enter declaratory judgments with respect to certain specific matters. See sections 7428, 7476, 7477, and 7478. The Commissioner's determination as to whether or not an estate qualifies for the payment of estate tax in installments under section 6166 or section 6166A does not create, or affect the amount of, a deficiency. Furthermore, it is not a matter with respect to which the Tax

Court has been granted authority to issue declaratory judgments, although a statute to that effect was proposed in the House of Representatives during discussions of the Tax Incentive Act of 1981. The Committee Reports state:

> Under present law, the decision of the Internal Revenue Service to deny an election to pay all or a portion of the estate tax attributable to closely held businesses generally is not subject to judicial review because no deficiency is involved. The committee believes that taxpayers should be provided with a judicial forum to resolve disputes involving an estate's eligibility for the deferral of estate tax attributable to interests in closely held businesses.
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> * * *
>
> Explanation of Provision.
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> * * *
>
> In addition, the [proposed] committee bill provides a procedure for obtaining a declaratory judgment with respect to (1) an estate's eligibility for deferred payment of estate taxes attributable to an interest in a closely held business under section 6166, * * *. Jurisdiction to issue a declaratory judgment is limited to the United States Tax Court and the determination of that court is final and conclusive and is not reviewable to any other court.

H. Rept. No. 97-201 (1981), 1981-2 C.B. 352, 388-389. The provision, however, was deleted in conference. See Conf. Rept. No. 97-215 (1981), 1981-2 C.B. 481, 511.

We conclude, therefore, that we do not have the statutory authority to review the respondent's determination that the estate cannot use the installment payment provisions of sections 6166 and 6166A. Nevertheless, it appears that our findings and decision with respect to the other issue should also dispose of this one.

To reflect the foregoing and the concessions of the parties, *Decision will be entered under Rule 155.*

UNITED STATES TAX COURT

Docket No. 5531-82

ESTATE OF H. FLOYD SHERROD, H. FLOYD SHERROD, JR., and ESTALEE SHERROD SANDLIN, CO-EXECUTORS,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed March 26, 1984, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is no deficiency in estate tax due from, nor overpayment due to the petitioners.

/s/ Perry Shields
Judge

Entered: July 23, 1984

* * * * *

STATUTES INVOLVED

1. Section 2032A of the Internal Revenue Code (26 U.S.C.) provides in pertinent part:

> (a) VALUE BASED ON USE UNDER WHICH PROPERTY QUALIFIES.—
>
> (1) GENERAL RULE.—If—
>
> (A) the decedent was (at the time of his death) a citizen or resident of the United States, and
>
> (B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2),
>
> then, for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property.
>
> . . . .
>
> (b) QUALIFIED REAL PROPERTY.—
>
> (1) IN GENERAL.—For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if—
>
> (A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—
>
> (i) on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and

(ii) was acquired from or passed from the decedent to a qualified heir of the decedent.

(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C),

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggravating 5 years or more during which—

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and

(D) such real property is designated in the agreement referred to in subsection (d)(2).

(2) QUALIFIED USE.—For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes, or

(B) use in a trade or business other than the trade or business of farming.

. . . .

(c) TAX TREATMENT OF DISPOSITIONS AND FAILURES TO USE FOR QUALIFIED USE.—

(1) IMPOSITION OF ADDITIONAL ESTATE TAX.—If, within 10 years after the decedent's death and before the death of the qualified heir—

(A) the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family), or

(B) the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent,

then there is hereby imposed an additional estate tax.

. . . .

(6) CESSATION OF QUALIFIED USE.—For purposes of paragraph (1)(B), real property shall cease to be used for the qualified use if—

(A) such property ceases to be used for the qualified use set forth in subparagraph (A) or (B) of subsection (b)(2) under which the property qualified under subsection (b), or

(B) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating more than 3 years during which—

(i) in the case of periods during which the property was held by the decedent, there was no material participation by the decedent or any member of his family in the operation of the farm or other business, and

(ii) in the case of periods during which the property was held by any qualified heir, there was no material participation by such qualified heir or any member of his family in the operation of the farm or other business.

. . . .

(e) DEFINITIONS; SPECIAL RULES.—For purposes of this section—

. . . .

(4) FARM.—The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

(5) FARMING PURPOSES.—The term "farming purposes" means—

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

(C) (i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market.

(6) MATERIAL PARTICIPATION.—Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self-employment).

2. Section 1402(a)(1) of the Internal Revenue Code (26 U.S.C.) provides:

(a) NET EARNINGS FROM SELF-EMPLOYMENT.—The term "net earnings from self-employment"

means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a)(8) from any trade or business carried on by a partnership of which he is a member, except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

> (1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity; . . .

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In the Supreme Court of the United States

OCTOBER TERM, 1986

H. FLOYD SHERROD, JR., AND ESTALEE SHERROD SANDLIN, CO-EXECUTORS OF THE ESTATE OF H. FLOYD SHERROD,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners contend that the decedent's lease of farmland to an unrelated party for a fixed rental constituted a "qualified use by the decedent" within the meaning of Section 2032A of the Internal Revenue Code,[1] thereby making the land eligible for "special use" valuation for federal estate tax purposes under that section. This contention was correctly rejected by the court of appeals, and there is no conflict among the circuits or other consideration warranting further review.

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

1. Property ordinarily is valued for federal estate tax purposes at its fair market value on the date of the decedent's death. This standard takes into account the property's "highest and best use," whether actual or potential. Congress became concerned that in some cases valuation of farmland at its highest and best use, such as for real estate development, produced such a large estate tax liability that the heirs of family farms had to liquidate the farms in order to pay the tax. See H.R. Rep. 94-1380, 94th Cong., 2d Sess. 21-22 (1976). Accordingly, to "encourage the continued use of property for farming and other small business purposes" (*ibid.*), Congress in 1976 enacted Section 2032A of the Code. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1856. That section permits qualifying real estate to be valued for estate tax purposes based on its actual use, rather than on the basis of its highest and best use. See I.R.C. § 2032A(e)(7).[2] This "actual use" valuation can reduce estate tax liability considerably, because it enables the executor to look primarily to the current return, which in the case of working family farms will often be relatively low, rather than to the investment value of the land.

Congress established several prerequisites to qualify for special use valuation. The condition relevant to this case is that at least 50% (in terms of fair market value) of the adjusted gross estate must consist of property "which * * * on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family" (I.R.C. § 2032A(b)(1)(A)).[3] The statute

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[2]As a general rule, this is done by capitalizing earnings that the existing business can be expected to yield.

[3]The phrase "by the decedent or a member of the decedent's family" was added to the statute in 1981, but made retroactively applicable to estates of decedents dying after December 31, 1976. See pages 5-6, *infra*.

defines "qualified use" as "the devotion of the property to any of the following: (A) use as a farm for farming purposes, or (B) use in a trade or business other than the trade or business of farming." I.R.C. § 2032A(b)(2). If an estate fails this 50 percent test, none of its assets are eligible for special use valuation.

2. Petitioners are co-executors of the estate of H. Floyd Sherrod, who died in 1977. His gross estate contained three distinct tracts of land totalling 1,478 acres, which consisted of timber land, crop land, and pasture land. The decedent and his son carried on a tree-farming business on the timber land. But neither the decedent nor anyone else in the family conducted any farming activities on the rest of the land. At the time of the decedent's death, and for some years before, the crop land and part of the pasture land were leased to non-family members for farming purposes. The tenants paid fixed cash rentals, rather than rent linked to the production of the land. Pet. App. 2a-4a, 13a.

On the estate tax return, petitioners claimed Section 2032A special use valuation, which was well below fair market value, for the 1,478 acres. On audit, the Commissioner disallowed that claim, computed the estate tax based on the fair market value of the property, and asserted a deficiency in estate tax. Petitioners challenged this determination in the Tax Court. Pet. App. 4a-5a.

3. a. The Tax Court held for the estate (Pet. App. 23a-41a). The court first determined that the decedent and his son put the timber land to a "qualified use" in an active timber farming business of their own (*id.* at 37a). That determination did not end the matter, however, because the fair market value of the timber land amounted to only 26% of the adjusted gross estate, well short of the 50% needed to satisfy Section 2032A(b)(1)(A). See Pet. App. 13a. The Tax Court went on to rule that the rest of the land was also

devoted to a "qualified use"—putting the estate over the 50 percent threshold—on the theory that the non-timber land constituted "an aid to" and "an integral part of" the timber land (*id.* at 37a-38a).

b. The court of appeals reversed (Pet. App. 1a-21a). The court agreed with the Tax Court that the decedent and his son conducted an active farm business on the timber land that met the "qualified use" requirement (*id.* at 12a). The court of appeals concluded, however, that the decedent's other land holdings did not meet that requirement. The court explained that the crop and pasture lands "d[id] not themselves fall within the qualified use category" (*id.* at 13a) and that they had no "discernible relationship, functional or otherwise," to his timber land (other than the fact of common ownership) (*id.* at 20a-21a). In contrast to the timber land, the court found, the crop and pasture land "was not employed in an active trade or business of the decedent or of a member of his family as is called for in the statute" (*id.* at 13a), and the decedent's sole involvement in the farming of the rented property was as "a landlord passively collecting a fixed rental from an unrelated party" (*id.* at 15a). The court further explained that it was "irrelevant" that the "unrelated" tenants ran a farm on the land they rented from the decedent (*id.* at 14a): "For the purposes of 'qualified use' inquiry, it does not matter to what use a tenant put the land; the focus is on what the decedent did with the land."

4. The decision below is correct. Petitioners contend (Pet. 5-11) that the rented land satisfied the "qualified use" test because it was used for farming. They submit that it makes no difference under the qualified use test that the land was farmed by unrelated parties and that the lease payments were not keyed to production. This contention is belied by the language of the statute, which states that property can qualify for special use valuation only if it "was being used for a qualified use *by the decedent or a member*

of the decedent's family" (I.R.C. § 2032A(b)(1) (emphasis added)). Petitioners totally ignore this language, which is flatly inconsistent with their submission. Moreover, the decision below, which accords with the other court of appeals' decisions on this issue (see *Martin* v. *Commissioner*, 783 F. 2d 81 (7th Cir. 1986); *Schuneman* v. *United States*, 783 F. 2d 694, 695 n.1, 698-699 & n.2 (7th Cir. 1986)), is further suppported by the policy of the statute, the legislative history, and the relevant Treasury regulations.

a. As originally enacted in 1976, Section 2032A granted special use valuation for property which, "on the date of the decedent's death, was being used for a qualified use" (26 U.S.C. (1976 ed.) 2032A(b)(1)(A)). The phrase "by the decedent or a member of the decedent's family" did not then appear in the statute. Even at that time, however, the legislative history of the 1976 Act made it clear that Congress intended to provide the preferential valuation only for land on which a decedent or a family member himself runs a farm, as distinguished from land on which an unrelated tenant runs a farm under a fixed rental arrangement with the decedent. The House report recited that "there must be a trade or business use," and that "[t]he mere passive rental of property will not qualify." H.R. Rep. 94-1380, *supra*, at 23. The report then continued as follows (*ibid.*):

> However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. For example, if A, the decedent, owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one-third interest in profits and capital, the real property could qualify for special use valuation.

Thus, the 1976 legislative history strongly evidences Congress's intent that a farming lease to an outsider that does not grant the decedent's family an interest in the profits of

the underlying business falls outside the category of uses that qualify for special estate tax treatment.

This conclusion is confirmed by Congress's subsequent action with respect to the language of the statute. In 1981, Congress added the words "by the decedent or a member of the decedent's family" after the term "qualified use." Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421(b)(1), 95 Stat. 306. Because this amendment was "primarily technical" (H.R. Rep. 97-201, 97th Cong., 1st Sess. 178 (1981)), it was made retroactive to the estates of decedents dying after December 31, 1976, the effective date of the 1976 legislation, and thus applies to the estate here. In enacting this amendment Congress reiterated that a fixed rental lease to an unrelated party does not satisfy the "qualified use" requirement of the statute. The House and Senate reports both state that "[t]he bill does not change the requirement of present law that [a qualified use] be an active trade or business use, as opposed to a passive, or investment use." H.R. Rep. 97-201, *supra*. at 169; see S. Rep. 97-144, 97th Cong., 1st Sess. 133 (1981). The Senate report then explained the distinction in detail (*ibid.* (footnote omitted)):

> For example, if a decedent has leased otherwise qualified real property to a son pursuant to a net cash lease, and the son conducts a farming operation on the property, the son's business use is attributed under the bill to the decedent for purposes of satisfying the qualified use requirement (sec. 2032A(b)(1)). On the other hand, during any period when the decedent leases the real property to a nonfamily member for use in a qualified use pursuant to a lease under which the rental is not substantially dependent upon production, the qualified use requirement is not satisfied.

Thus, there can be little doubt that Congress did not intend to confer the benefits of Section 2032A special use valuation

on estates like the one in this case, where the family has no substantial involvement in farming operations.

b. The applicable Treasury regulation is in accord with the terms of the statute and its legislative history. It provides that "[u]nder section 2032A, the term trade or business applies only to an active business such as * * * the raising of agricultural or horticultural commodities, as distinguished from passive investment activities." Treas. Reg. § 20.2032A-3(b)(1). The regulation specifies that "[t]he mere passive rental of property to a party other than a member of the decedent's family will not qualify." Rather, "[t]he decedent or a member of the decedent's family must own an equity interest in the farm operation." *Ibid.* Thus, the court of appeals' decision is strongly supported by the well established rule that interpretive rulings by the Treasury, "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)).

5. Petitioners do not discuss the language of Section 2032A(b)(1)(A)(i) or the relevant regulation and legislative history. Instead they look to another portion of the statute, Section 2032A(b)(1)(B) and (C), and argue that the court of appeals' decision must be wrong because it makes the "material participation" in 25% of the estate requirement superfluous (see Pet. 9). Rather, petitioners maintain, this latter section contains the only statutory requirement of family participation in the qualified use and therefore the 50% requirement is satisfied as long as the land is used for farming, even if the family's participation at the time of death is no more than collecting a fixed rental for the land. This contention is plainly mistaken. First, Section 2032A(b)(1)(A)(i) explicitly requires family participation in the qualified use for purposes of the 50% test. Second, it is

manifestly untrue that the court of appeals' decision makes superfluous the "material participation" requirement of Subsections (B) and (C). Unlike the provision at issue here, which pertains only to the use of the land on the date of the decedent's death, those subsections establish a test directed at the use of the property over the previous eight years. Those subsections prevent the decedent from taking action just before his death in order to qualify for special use treatment and seek to ensure that only properties that have genuinely been established as family farms or businesses will receive that treatment. For example, a property that is converted to use as a family farm one year before the decedent's death may satisfy the 50% test of Subsection (A), but it will not satisfy the 25% test of Subsections (B) and (C)—which petitioners erroneously characterize as superfluous. The two tests are distinct and are directed at different possible problems.

Petitioners also suggest that the decision below is at odds with the policies of the statute because a decedent who in his last years is too infirm to "materially participate" in farming will be unable to qualify for special use valuation—a result that Congress assertedly never intended (see Pet. 12). The decision below has no such effect. As the court of appeals recognized (Pet. App. 13a-15a), a decedent who leases his land to a relative for farming purposes, or who owns a substantial equity or cropshare interest in his tenant's farming operation, will meet the test of "qualified use." See *Schuneman* v. *United States, supra*. Thus, the mere fact that the owner of farmland has become physically unable to farm it personally does not mean that he cannot take advantage of the special use provisions as long as a relative continues to farm the land or the owner retains a substantial financial stake in the farming operation. This is fully in accord with the policy of the statute, which is not to give a special tax break to all farmers, but rather is limited to

preserving "family farms" against the possibility of dissolution because of estate tax liability. In the words of the court of appeals (Pet. App. 13a), the 50% test "is intended to confine the statute's benefits to those estates which would in fact be likely to experience a genuine liquidity problem because a major part of the estate's assets is tied up in a farm or other closely-held family business." See H.R. Rep. 97-201, *supra*, at 168 (statute aimed at protecting "family owned and operated" businesses). The decision below is faithful to that policy; petitioner's expansive interpretation of the special use provisions would undermine it.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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